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TREASURY FOR INTERNATIONAL AFFAIRS - KATHIASSEN AND JROSE

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SUBJECT: TURKISH CENTRAL BANK GOVERNOR EXPRESSES CONFIDENCE
TO A/S SULLIVAN

¶1. (SBU) Summary: Central Bank Governor Durmus Yilmaz told A/S Sullivan that the Bank was hopeful it could achieve its 2008 target and would attain a respectable 5.1% in 2007 if current conditions prevailed for the remainder of the year. While this is below the official target (of 4%), the Governor concluded that increasing the target would do more to undermine credibility than leaving it intact. Yilmaz thought the composition of the deficit, with a high proportion of goods, reflected that hence of a strong community.

Converging to 4% Target by 2008

¶2. (SBU) In a February 10 meeting on the margins of the U.S.-Turkey Bilateral Economic Partnership Commission, Central Bank Governor Durmus Yilmaz told A/S Sullivan he believed Turkey's inflation targets were attainable by 2008. Even by yearend 2007, Yilmaz said that 5.1% inflation could be achieved if three conditions prevailed: oil at or below \$55 per barrel; no change in Turkish risk premium and the Central Bank maintains constant policy rates for the first three quarters. Yilmaz said the Bank was still concerned about unprocessed food prices -- a key source of January's high inflation rate -- which are highly dependent on rainfall.

Why the Bank Maintained the Inflation Target

¶3. (SBU) A/S Sullivan asked why the Bank had not changed its targets, as the impact of last year's depreciation and the high January figure indicated that the 2007 target was likely unattainable. The Governor said the Bank had had extensive deliberations, both internally and with the IMF, on whether to revise the targets, and was faced with a potential loss of credibility either way. Ultimately, the Governor concluded that an upward revision would do more damage to the Bank's credibility because it would contribute to higher inflation expectations, adding further upward pressure on prices. Moreover, the Bank expects market participants to understand that the 2006 inflation target was missed because of factors outside the Bank's control, notably the fall in the exchange rate and the rise in energy prices.

Downplaying Current Account Risk

¶4. (SBU) Yilmaz recognized that Turkey's large current

account deficit was a key factor behind why the May-June Emerging Market volatility had a greater impact on Turkey than other EM's. He emphasized the importance of continued adherence to tight fiscal policy (e.g, 6.5% primary surplus target). The Central Bank estimates that GDP growth was moderate, at 4.5% in 2006, and that slower growth should help stabilize the current account. Yilmaz said that the rate hikes in response to the depreciation of the lira were a key factor in the 2006 slowdown in GDP growth. Like Minister Babacan (septel), Yilmaz said that the risks associated with the large current account deficit were mitigated by its improved composition. He also noted that with a low savings rate and 800,000 to 900,000 young people coming into the job market every year, Turkey needs investment. This can be seen in the substantial proportion of capital goods in the Turkey's imports.

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CentrQl Bank Independence and Focus on Communication

15. (SBU) In reply to A/S Sullivan's question about Central Bank independence, Yilmaz said, "The Central Bank is not a Republic within a Republic." He noted that the country is governed by the Government, but the law gives the Central Bank independence and "we are working to maintain it." If the inflation trend is being affected, Yilmaz said he would not hesitate to use the Bank's independence for the good of the country. Vice-Governor Erdem Basci pointed out that the

Bank benefits from the public's experience of high inflation and the consensus in favor of achieving price stability. Yilmaz went on to say that, consciously or unconsciously, people know that the nineteen quarters of high growth have coincided with declining inflation.

16. (SBU) Yilmaz also emphasized that he fully understands that importance of strong communication with the politicians, the public and the financial markets. The Governor said that he formally describes Bank policy to parliament twice a year, issues a open letters to the Government must report to the government and the IMF when it deviates from its inflation target. The bank also issues regular inflation reports, a financial stability report, and conducts inflation expectation surveys. The Bank recently increased the horizon of these surveys from 18 to 24 months ahead, in an effort to keep the focus on the achievability of its 2008 target. The Bank holds a board meeting outside Ankara every quarter and uses the occasion to have the Governor appear before local business groups, as it did recently in Bursa. Given the crucial role of foreign investors in Turkish financial markets, Basci and Yilmaz described their focus on better and more timely translations of the minutes of Monetary Policy Committee (MPC) meetings and the inflation report. The Bank has hired more translators but senior management personally translates the MPC statement the same evening.

Redollarization Only Temporary

17. (SBU) U.S. Treasury Office Director Karen Mathiasen briefly touched on developments in the U.S. economy and passed on some of the concerns expressed to her by Istanbul market analysts. When she noted the recent g-term trend towards a smapeign currency-denominanealthy Turkish individuals used these funds, the GoveQthe share of foreign eted deposits would resue its declining trend.

A/S Sulivan cleared this cable.

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WILSON